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Banks and Banking-Pledging Assets

RECENT CASE NOTES

Banks and Banking—Pledging Assets. Plaintiff Railway Company was a depositor in a national bank. To secure it as such, the bank had pledged bonds and held them for the railway in the trust department of the bank. The bank failed and defendant was appointed receiver. Railway made proof as a secured creditor, but the receiver denied the validity of the pledge and ten-

dered a dividend check only for the amount to which the railway would have been entitled as an unsecured creditor. Thereupon, the railway brought suit in federal district court against the receiver praying that the bonds be delivered to it; or that they be sold for its benefit; or that the claim be paid in full with interest. The receiver filed a cross-bill praying the bank's title to the bonds be quieted. Court dismissed the bill and entered a decree for the receiver on the cross-bill holding that the pledge was void. Circuit court of appeals affirmed the decision. Held, on appeal to the United States Supreme Court, affirmed.[1]

Statute of Illinois required the treasurer of the city to make deposits in bank of all moneys received by him, and also required the treasurer, before any such deposits were made, to execute a bond with sureties conditioned that the bank would keep and account for said money. Fidelity Company agreed to become surety on the treasurer's bond, provided he would get a bank which would give collateral security for the repayment of the deposits. Defendant National Bank agreed to do this, and delivered to another bank, as escrow agent, certain bonds. Amendment of 1930 to National Bank Act of 1864 allows national banks to pledge assets to secure funds of a state or political subdivision thereof, if it is located in a state in which the state banks are so authorized. The bank failed and its receiver brought suit in federal district court against the city, its treasurer, the surety, and the escrow agent praying that the pledge be declared void and the bonds be delivered to him. District court dismissed the bill. Its decree was reversed by the Circuit Court of Appeals holding that the pledge was void, inasmuch as Illinois had not conferred upon its banks the power to pledge assets to secure deposits of political subdivisions of the state. Held, on appeal to the United States Supreme Court, affirmed.[2]

This note is supplementary to a previous note[3] which discussed the right of a bank to pledge its assets to secure deposits. At that time, the decisions of the state courts were in sharp conflict and the few decisions by the lower federal courts, although holding such pledges void, were by divided courts. Nevertheless, in that note, the position was taken that, outside of statutory authorization, a bank had no right to pledge its assets to secure deposits because, it seemed, this view was in conformity with business practices and with the manifest public policy to protect the small depositor. In light of the confusion in the cases, it is indeed gratifying to have a declaration by the United States Supreme Court concerning the right of a national bank to pledge its assets to secure both public and private deposits where there is no statutory approval. Justice Brandeis, speaking for the court, in both cases, points out the fallacy in every argument that has been propounded to sustain the validity of such pledges.

First, there is no basis for the claim that the power to pledge assets to secure deposits is incident and necessary to carry on the business of deposit banking. For, as the court points out,[4] from the establishment of the national banking system in 1864 to March 1, 1933, 2,159 national banks have failed[5] but only two other reported cases have been found involving a pledge of assets to secure private deposits. Surely such action cannot be deemed a necessary incident to a business when in so few instances it has been taken.

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1 Texas & Pac. Ry. Co. v. Pottorff (1934), 54 S. Ct. 416.
2 City of Marion, Ill., v. Sneeden (1934), 54 S. Ct. 421.
3 9 Ind. L. J. 322.
4 Texas & Pac. Ry. Co. v. Pottorff (1934), 54 S. Ct. 416, 417; City of Marion, Ill., v. Sneeden (1934), 54 S. Ct. 421, 422.
5 Annual Report of the Comptroller of the Currency (1932) 148. Federal Reserve Bulletin (1933) 144.

Second, the argument that the Amendment of 1930 was passed merely to settle any doubts as to the power of national banks to pledge their assets to secure deposits is without avail. For if the amendment had been passed merely to settle such doubts, the amendment would not have been made to section 45 of the National Banking Act of 1864 which provides that the Secretary of the Treasury might deposit money in national banks upon receiving satisfactory security, but would have been made to section 8 which contains the grant of incidental powers.[6]

Third, to permit such a pledge would be inconsistent with many provisions of the National Banking Act which are designed to ensure in case of failure of the bank, a ratable distribution of the assets among the depositors. "The effect of a pledge is to withdraw for the benefit of one depositor part of the fund to which all look for protection."[7]

Fourth, the contention that a bank may pledge its assets to secure a loan, that a deposit is a loan, and therefore a bank may pledge its assets to secure, is fallacious. As Justice Brandeis writes, "The difference between deposits and loans is fundamental and far-reaching. The amount of the deposits is commonly accepted as measure of a bank's success; an increase of deposits is evidence of increased prosperity. The depositor does not think of himself as lending money to the bank. The modern deposit grew out of the older form of deposit in which the fund was held separate and intact, and the sole purpose of the deposit was safe-keeping. Safe-keeping is still an important function of deposit banking; and from the point of view of most depositors the chief one. Borrowing by a bank (as distinguished from a rediscount) is commonly regarded as evidence of weakness."[8]

Fifth, the receiver is not estopped to deny the validity of the pledge, for the unauthorized pledge reduces the assets available to the general creditors, and it is the duty of the receiver to take steps to set aside transactions which fraudulently or illegally reduce the assets available to general creditors, even though the bank itself is not in a position to do so.[9]

Lastly, the receiver may assert the invalidity of the pledge without making restitution by paying the pledgee's claim in full; the court saying, "Such claim under the doctrine of unjust enrichment is assimilated to an obligation of contract; and does not in the absence of an identifiable res and a constructive trust based on special circumstances of misconduct, confer a preference over other creditors."[10]

[6] Texas & Pac. Ry. Co. v. Pottorff (1934), 54 S. Ct. 416, 419; City of Marion, Ill., v. Sneeden (1934), 54 S. Ct. 421, 422.

[7] Texas & Pac. Ry. Co. v. Pottorff (1934), 54 S. Ct. 416, 418. See also, Smith v. Baltimore and O. Ry. Co. (D. C. 1931), 48 Fed. (2nd) 861, affirmed in (C. C. A. 1932), 56 Fed. (2nd) 801; Divide County v. Baird (1927), 55 N. D. 45, 212 N. W. 236; Commercial Bank and Trust Co. v. Citizens' Trust and Guaranty Co. (1913), 153 Ky. 566, 156 S. W. 160; Hougen, The Right of Banks to Pledge Their Assets to Secure General Deposits (1928), 2 Dak. L. J. 68.

[8] Texas & Pac. Ry. Co. v. Pottorff (1934), 54 S. Ct. 416, 419, 420; see also, Farmers and Merchants State Bank v. School Dist. (1928), 174 Minn. 286, 219 N. W. 163; Hunt v. Hopley (1903), 120 Iowa 695, 95 N. W. 205; Boyd v. Schneider et al. (C. C. A. 1904), 131 Fed. 223. Arkansas-Louisiana Highway Improvement Dist. v. Taylor (1928), 177 Ark. 440, 6 S. W. (2nd) 533; Foster v. City of Longview (Texas 1930), 26 S. W. (2nd) 1059.

[9] Texas & Pac. Ry. Co. v. Pottorff (1934), 54 S. Ct. 416, 420; see also King v. Pomeroy (C. C. A. 1903), 121 Fed. 287; Hamor v. Taylor-Rice Engineering Co. (C. C. 1897), 84 Fed. 392, 399; In re O'Gara & McGuire Inc. (D. C. 1919), 259 Fed. 935, 936; In re K-T Sandwich Shoppe (D. C. 1929), 34 Fed. (2nd) 962, 963.

[10] Texas & Pac. Ry. Co. v. Pottorff (1934), 54 S. Ct. 416, 420; see also, Schuyler v. Littlefield (1914), 232 U. S. 707, 34 S. Ct. 466; Wuerpel v. Commercial Germania Trust & Savings Bank (C. C. A. 1917), 238 Fed. 269, 272, 273; Knauth v. Knight (C. C. A. 1919), 255 Fed. 677; Blakey v. Brinson (1932), 286 U. S. 254, 52 S. Ct. 516.

These two cases will lay down a binding rule for national banks and the lower federal courts, and it is hoped, by the writer, that this declaration by the highest court in the land will carry sufficient weight to persuade state courts to take a like view. S. E. M.